

Report on
2003 Limited Inspection
of KPMG LLP

Issued by the
Public Company Accounting Oversight Board

August 26, 2004

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

**PORTIONS OF THE COMPLETE REPORT ARE OMITTED
FROM THIS DOCUMENT IN ORDER TO COMPLY WITH
SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002**

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the regulatory supervisory context in which this report was prepared. Discussions of the Board's or Board staff's views on such matters are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. In connection with inspections of registered public accounting firms, the Board and its staff consider whether the firm, in its audits of financial statements, has failed to identify departures from Generally Accepted Accounting Principles (GAAP). This report's descriptions of such failures necessarily involve descriptions of the Board and Board staff's view of the relevant GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("Commission"). The description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.
4. The audit engagements reviewed during this limited inspection concerned financial statements for periods that ended before the relevant standards (then referred to as Generally Accepted Auditing Standards or "GAAS") were adopted by the PCAOB on an interim basis as the PCAOB standards that, under the Act, now govern the audits of the financial statements of issuers. For consistency with other Board action related to PCAOB standards, this inspection report refers to the applicable standards as PCAOB standards even with respect to periods before the Board adopted the standards. *Cf.* Auditing Standard No. 1 – References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board, PCAOB Release No. 2003-025 (Dec. 17, 2003) (approved by the Commission, May 14, 2004).

INSPECTION REPORT OVERVIEW

In 2003, the Public Company Accounting Oversight Board conducted inspections of public accounting firms for the first time. The Board inaugurated its inspection program with limited inspections of the four largest U.S. public accounting firms, including KPMG LLP, the subject of this report. In those inspections, the Board identified significant audit and accounting issues that were missed by the firms, and identified concerns about significant aspects of each firm's quality controls systems. The Board's inspection reports describe those issues. Because Board inspections and inspection reports are new, however, the Board offers a few remarks by way of providing readers with a context for the observations described in this report.

The Board's statutorily prescribed mission is to oversee auditors of public companies in order to protect the interests of investors and to further the public interest in the preparation of informative, fair, and independent audit reports. To advance that mission, Board inspections take up the basic task that had been the province of the accounting profession's peer review system, but Board inspections do not duplicate the programs and approach of peer review.

Board inspections do, of course, examine technical compliance with professional accounting and auditing standards, but Board inspections also examine the business context in which audits are performed, and the ways in which that context influences firm audit practices. Among other things, the Board looks at firm culture, the relationships between a firm's audit practice and its other practices, and the relationship between a firm's national office and its engagement personnel in field and affiliate offices. Through this approach, the Board believes that it can help bring about constructive change in the types of practices that contributed to the most serious financial reporting and auditing failures of the last few years.

Toward that end, an essential ingredient of the Board inspection process is an unflinching candor with firms about the points on which we see a need for improvement. That emphasis may often result in inspection reports that appear to be laden with criticism of a firm's policies, practices, and audit performance, and less concerned with a recitation of a firm's strengths. That is because, from the Board's perspective, the inspection reports are not intended to serve as balanced report cards, rating tools, or potential marketing aids for any firm. The reports are intended principally to focus our inspection-related dialogue with a firm on those areas where improvement is either required for compliance with relevant standards and rules, or is likely to enhance the quality of the firm's audit practice.

The reports' emphasis on these criticisms, however, should not be understood to reflect any broad negative assessment. The four firms inspected in 2003 are made up of thousands of audit professionals, have developed multiple volumes of quality control policies, and perform audits for a combined total of more than 10,000 public companies. It would be a mistake to construe the Board's 2003 inspection findings as suggesting that any of these firms is incapable of providing high quality audit services.

Moreover, the Board does not doubt that the bulk of the firms' audit professionals consists of skillful and dedicated accountants who strive – at times against the competing priorities of the large and complex business of the firms – to make audit quality their top priority. The Board is encouraged by the increasing tendency of persons at the highest levels of the firms to speak of the need for a renewed commitment to audit quality as the firm's top priority. The Board is also encouraged by the firms' recognition of the value of the Board's inspection process. The Board will continue to use its inspection authority to focus the firms on aspects of their practice that may stand as an impediment to the highest quality audit performance.

PCAOB Release No. 104-2004-004

2003 LIMITED INSPECTION OF KPMG LLP

In 2003, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted a limited inspection of KPMG LLP ("KPMG"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part III of the report. Part III of the report consists of the firm's comments on a draft of the report.^{1/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{2/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

^{1/} The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change in the report.

^{2/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's staff ("the staff") performed a limited inspection of KPMG during the period from June 2003 through December 2003. The staff performed field work at KPMG's national office and at four of its practice offices. The staff also observed and tested aspects of KPMG's internal inspection program at five additional practice offices.

The limited inspection included a review of certain portions of selected audit engagements and a review of policies and procedures in the following seven functional areas, which were selected based on criteria identified by the Board:

- Tone at the top;
- Practices for partner evaluation, compensation, promotion, and assignment of responsibility;
- Independence implications of non-audit services; business ventures, alliances and arrangements; and commissions and contingent fees;
- Client acceptance and retention;
- The firm's internal inspection program;
- Practices for establishment and communication of audit policies, procedures and methodologies, including training; and
- The supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. audit clients.

Part I.A below provides a description of the steps that the staff took with respect to the review of audit engagements and the review of the seven functional areas. Following that, Part I.B describes, at a general level, certain observations concerning KPMG's audit performance as observed in the review of audit engagements. The public portion of this report then concludes with certain general observations in Part I.C.

A. The Inspection Process

The staff carried out extensive procedures related to KPMG's public company audit practice. Even so, the Board emphasizes the limited nature of this initial inspection of KPMG compared to the scope of the inspections that the Board intends to conduct for large firms going forward. Although the practical considerations in creating a new inspection program (including the time required to enlist a sufficient number of appropriately skilled staff) prevented the Board from conducting full-scale inspections in 2003, the Board determined that conducting limited inspections was feasible and would advance the public interest by providing a foundation for the full-scale inspections to come.

1. Review of Selected Audit Engagements

At the outset of the inspection, the staff selected 16 audit engagements to review. The staff chose the engagements according to the Board's own criteria. As with any Board inspection, KPMG was not allowed an opportunity to limit or to influence the selection process.

For each audit engagement selected, the staff began by reviewing the issuer's financial statements and Form 10-K. The staff selected certain subject matter areas for review and, at the practice offices, inspected the engagement team's work papers and interviewed engagement personnel regarding those subject matter areas. The subject areas for review included, but were not limited to, revenues, reserves or estimated liabilities, related party transactions, supervision of work performed by foreign affiliates, and the assessment of risk by the audit team. The staff analyzed potential adjustments to the issuer's financial statements that had been identified during the audit but not recorded in the financial statements. The staff also interviewed, by phone, the Chair of the issuer's audit committee and reviewed communications between the firm and the audit committee.

When the staff identified a potential issue, the staff discussed the issue with members of the audit engagement team. If the staff was unable to resolve the issue through this discussion and any resultant review of additional work papers or other documentation, the staff ordinarily requested that the engagement team consult with KPMG's Department of Professional Practice ("DPP") in its national office. In many cases, this consultation process resulted in resolution of the matter, either because DPP agreed with the position the staff had taken and the firm or the issuer took adequate steps, in light of the significance of the error, to remedy the exception, or because DPP was able to provide additional information that effectively addressed the staff's concerns.

2. Review of Seven Functional Areas

The staff conducted the procedures related to the review of the seven functional areas primarily at KPMG's national office. With respect to six of the functional areas, the staff also conducted procedures at the four practice offices.^{3/}

At the national office, the staff interviewed numerous members of the firm's leadership; read and evaluated extensive documentation of firm policies and procedures; analyzed other source documents relating to the functional areas inspected; and reviewed communications from the national office to firm personnel. These actions were performed in order to understand KPMG's policies and procedures in the seven functional areas, evaluate their design and operation, and test compliance on a limited basis with those policies and procedures.

At the practice offices, the staff analyzed the consistency with which the practice offices applied the policies and procedures established by the national office, and evaluated whether communications from the national office were effective and were applied and reinforced within the practice offices. To accomplish these goals, the staff interviewed office leadership and audit partners and senior managers and reviewed relevant documentation.

At the practice offices, the Board staff also conducted focus groups of KPMG staff, outside the presence of office leadership and on a not-for-attribution basis. The Board staff conducted separate groups for audit managers and for lower-level audit staff. In these groups, the staff facilitated discussion by the participants of their understanding of the messages conveyed by firm and office leadership and other personnel, and how these messages might affect the participants' actions.

Naturally, each of the functional areas reviewed involved a scope of materials and procedures particular to it. A more detailed description of the scope with respect to each of the seven functional areas is set out below.

^{3/} The functional area not specifically reviewed at the practice offices is the establishment and communication of audit policies, procedures and methodologies, including training.

a. *Review of Tone at the Top*

The primary objective of the review of the firm's "tone at the top" was to assess whether the actions and communications of firm leadership demonstrate a commitment to audit quality and compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission, and professional standards in connection with the firm's performance of audits, issuance of audit reports, and related matters involving issuers. Toward that end, the staff read, reviewed, and analyzed the following information at the national office:

- KPMG's code of conduct for partners and employees;
- Documentation related to internal sources of ethics guidance;
- Organizational charts, duties of the firm's governing board and biographies of the firm's board members;
- Narratives concerning reporting relationships;
- Ten public company audit proposals;
- The most recent client and audit committee survey used to evaluate satisfaction with services provided by the firm;
- The KPMG audit manual;
- The strategic business plan of the firm;
- The financing structure of the firm;
- Descriptions of selected industry programs;
- Communications from top management consisting of speech transcripts, policy statements, and internal memoranda;
- The agendas and minutes of the management committee and governing Board;
- The video of the fall 2002 Conference for Financial Services Industry Partners and Managers; and

- A sample of area and local office internal communications.

In addition, the staff's work at the national office included interviews of 19 KPMG board members, top management, management committee members, audit and technical leaders, industry program leaders and functional leaders of the firm.

The staff also performed procedures concerning "tone at the top" at four of the practice offices. At those offices, the staff interviewed the leadership, including area and office audit leadership, area and office risk management partners and office managing partners. In addition, the staff interviewed 13 audit partners and six audit senior managers to obtain their perspective on messages and or communications from the firm's leadership related to audit quality and the "tone at the top."

The staff also conducted or participated in nine focus groups including two focus groups conducted as part of the firm's internal inspection process attended by the staff. Separate focus groups were conducted with six to 10 audit managers or senior managers and audit staff personnel. The purpose of the focus group meetings was to assess the participants' understanding of, among other things, the messages conveyed by firm and office leadership and their supervisors and how such messages might affect the participants' actions on audits. The staff also obtained the participants' views on the "tone at the top."

b. Review of Partner Evaluation, Compensation, Promotion, and Assignment of Responsibility

The objectives of the inspection procedures in this area were to assess the firm's current policies and procedures for evaluating partner performance and determining partner compensation; to determine the relative weight the firm gives to marketing as opposed to audit quality and technical competence in admitting new partners, measuring partner performance, establishing partner compensation, assigning responsibilities to partners, and disciplining partners; and to evaluate whether the design of the measurement, evaluation and compensation processes as documented and communicated could be expected to achieve the objectives of promoting audit quality.

In pursuit of these objectives, the staff requested, in July 2003, that the firm provide certain documentation related to the firm's practices for audit partner evaluation, compensation, promotion, and assignment of responsibility. The staff split its work into two phases. The review of policies and process, including the evaluation forms, communications to partners and templates to be used for summarizing and reporting the fiscal 2003 evaluations and compensation

adjustments occurred first. The staff subsequently analyzed the actual compensation adjustments and awards and the underlying evaluations.

As part of its procedures, the staff read, reviewed, and analyzed the firm's policies and procedures related to the following:

- Evaluation of partner performance;
- Determination and method of partner compensation;
- Process for nomination and admission of new partners; and
- Assignment of duties, termination and re-assignment of partners, including a description of the measures used by management to monitor and evaluate partner performance metrics (e.g., chargeable ratios, hours supervised, revenue billed or participation in marketing efforts).

In addition, the staff analyzed schedules that included, among other things, each partner's name, business unit, geographic area, year admitted to the partnership, current and prior year's overall evaluation, prior year's base income and incentive compensation awards, and the approved compensation for the fiscal 2003 cycle. The information also indicated resignations, terminations, and early retirements of partners in fiscal 2003.

The staff also performed the following procedures:

- Selected a sample of 39 partners and reviewed each partner's fiscal 2003 evaluation as included in his or her personnel file and the documentation of the factors utilized by the Firm in setting the partner's compensation;
- Selected a sample of 25 newly admitted partners and 25 direct admits in order to assess whether the stated rationale for the decision to admit to the partnership was consistent with firm policies and the individual's files, and to evaluate the roles that technical competence and sales or marketing played in the decision;
- Selected a sample of 10 partners who resigned (voluntarily or at the firm's request) or who were early retirements during the year, assessed whether the stated rationale for the action was consistent with firm policies and the individual's files, and evaluated the roles

that technical competence and sales or marketing played in the decision;

- Interviewed the firm's Vice Chair Assurance and Advisory Services, Vice Chair Risk and Regulatory Matters, Vice Chair Human Resources, CFO, COO and top technical partner in order to understand the process of compensating partners;
- Interviewed four Area Managing Partners, the partner responsible for outplacement and certain local Business Unit Professional Practice Partners ("BUPPPs") who provide input into audit partner evaluation;
- Interviewed the firm's board member who heads the compensation committee that provides oversight of the process;
- Interviewed the partner in charge of each of the 16 audit engagements the staff reviewed, as well as one other partner assigned to each engagement (e.g., tax, computer audit specialist or derivatives specialist), if applicable, to determine how the partners allocate their time during the year among various activities such as auditing, maintaining client relationships, sales or marketing activities, or training, coaching and recruiting, and the relationship between those allocations and the partners' perceptions of the relative effects that audit quality, selling, and technical competence have on their compensation, evaluation, and advancement within the partner ranks; and
- Reviewed the fiscal 2003 evaluations in the personnel files of the 16 audit partners referred to above.

c. Review of Independence Policies

The objectives of the inspection procedures in this area included gaining an understanding of certain KPMG policies and procedures relating to the firm's compliance with independence requirements. In particular, the staff focused on independence issues related to the provision of non-audit services to issuer clients and to the firm's business ventures, alliances, and arrangements. The staff also focused on the firm's internal processes for monitoring compliance with those policies. To accomplish these objectives, the staff read, reviewed and analyzed the following information at the national office:

- Policies, procedures, guidance materials, and Professional Practice Letters ("PPLs") related to independence (including independence consultations) for non-audit services to audit clients by service line;
- Training programs on independence;
- A list of ventures and alliances and a description of the nature and purpose of each venture or alliance;
- A description of the process for establishing an alliance;
- A description of the procedures for independence consultations;
- 25 independence consultation inquiries selected from the independence consultation log. Selections were made from a list of all independence consultation inquiries between August 2002 and July 2003; and
- The firm's internal inspection program as it relates to monitoring compliance with the firm's independence policies and procedures.

In addition, the staff interviewed two partners in the independence group within DPP, including the partner-in-charge of the independence group. The staff also inquired as to any pending SEC matters related to independence.

The staff's procedures at the four practice offices included interviews with 13 audit partners on engagements the staff reviewed, as well as eight other audit partners, two regional area risk managing partners and three Business Unit Professional Practice Partners ("BUPPPs"), regarding the provision of non-audit services to issuer audit clients, services to non-audit clients, and percentage of time devoted to sales activities. The staff also evaluated whether the 16 audit engagements complied with the independence rules and the firm's policies in this area. This procedure included identifying any non-audit services performed for the issuer, any business ventures, alliances, or arrangements with the issuer, and the fee arrangements; and reading and evaluating the most recent letter provided to KPMG's issuer clients' audit committees pursuant to the terms of Independence Standards Board ("ISB") Standard No. 1, *Independence Discussions with Audit Committees*.

d. Review of Client Acceptance and Retention Policies

The primary objectives of inspection procedures in this area were to evaluate whether the firm's client acceptance and retention policies and

procedures reasonably assure that it is not associated with issuers whose management lacks integrity, that it undertakes only engagements within its professional competence, and that it appropriately consider the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the staff read, reviewed and analyzed the following information at KPMG's national office:

- Documentation concerning the firm's information-gathering practices related to acceptance and retention of clients;
- Detailed information gathered pursuant to those practices;
- The policies and procedures for acceptance and continuance of public audit clients and non-public companies likely to go public within two years, including policies and guidance related to required acceptance and continuance approvals and clients designated as higher risk;
- A list of all issuer clients that had changed to other auditors during the period August 2002 - July 2003, which included the KPMG office that had audited the client, the new firm, and whether the firm was dismissed or resigned;
- For each former client, a copy of the Form 8-K, the firm's resignation letter to the issuer client, and the auditor cessation letter sent to the SEC; and
- A list of all new issuer clients for the period August 2002 - July 2003, which included the registrant's name, the KPMG office, the predecessor audit firm, whether the change involved situations described in Item 304(a)(1)(v) of SEC Regulation S-K, and whether the predecessor audit firm was dismissed or resigned.

The staff also:

- Attended a training presentation by the firm on the firm's system for considering acceptance or continuance of clients;
- Reviewed the documentation related to certain "lost clients" for compliance with the firm's policies and procedures and professional and regulatory requirements in this area;

- Interviewed the Vice Chair Risk and Regulatory Matters and the Vice Chair Assurance and Advisory Services, the partner in charge of the firm's internal review program, certain firm industry Chairs and local and area risk management partners to obtain an understanding of the client acceptance and continuance practices and procedures;
- Read and evaluated 20 issuer client acceptances and 15 issuer client retentions and evaluated whether the risk evaluation was properly completed and approved; and
- Considered whether the firm had accepted or retained clients that should have been rejected or dismissed according to KPMG policy.

The staff conducted procedures in this functional area at the four practice offices as well. With respect to four new issuer clients and 13 existing issuer clients that were higher-rated risks, the staff interviewed the engagement partners and read and evaluated the client acceptances and retentions in order to understand the approval process, ascertain reasons for acceptance/continuance, and evaluate whether specific risk mitigation steps, if any, were performed and documented. On a test basis the staff also evaluated whether the audit planning documentation incorporated the specific actions, if any, and the impact upon the audit scope for the next audit cycle.

e. Review of Internal Inspection Program

As part of the national office procedures, the staff reviewed KPMG's internal inspection program, known as the Quality Performance Review Program ("QPRP"). The staff reviewed aspects of the performance of the 2003 QPRP in order to evaluate the effectiveness of the firm's annual internal inspection program in enhancing audit quality, including assessing the results of the program and the remedial actions taken. The staff also observed and tested the conduct of the internal inspection program in five practice offices to assess compliance with the quality control standards adopted by the Board.

The staff read, reviewed and analyzed the following information at KPMG's national office:

- Policies and procedures for the internal inspection program, including the program's goals and objectives, and methods of selection of offices, partners and engagements to be reviewed;

- The internal inspection engagement questionnaires, engagement information forms used in the selection process, the reviewer profile forms and a copy of the issue sheets used to document findings by the reviewer;
- Results of the current year's internal inspection program, including the summary issue sheets and evaluation of the results; and
- Documentation of presentations to the KPMG Board and communications to partners and professional staff regarding the 2003 inspection program results.

Further, the staff conducted interviews with the partner in charge of the internal inspection program in order to gain an understanding of the program and process. The staff interviewed members of KPMG's Board, its Chairman and CEO, its COO, the partner in charge of risk management, major service line leaders, and the firm's top technical partner regarding the internal inspection program and its effectiveness. In the practice offices, the staff interviewed the area leadership, including the partners in charge of the areas, partners in charge of audit quality, partners in charge of risk management, and selected audit business and professional leaders regarding the internal inspection program and its effectiveness. The staff interviewed 11 audit partners and four audit senior managers regarding the internal inspection program and its effectiveness.

The staff also reviewed and tested the conduct of the internal inspection program for one region, principally at one practice office. In this regard, the staff:

- reviewed and evaluated the qualifications and experience of the firm's inspectors;
- observed internal focus group meetings for KPMG managers in one practice office and for KPMG senior accountants in another practice office;
- reviewed four of the 17 issuer client engagements reviewed by the internal inspection teams. For these four engagements, the staff:
 - read the issuer's financial statements and the firm's audit report;
 - read the engagement team's overall summary memorandum;

- reviewed the engagement team's work papers for several areas;
- read the negative response forms (the forms used by internal inspection teams to document findings) and other documentation of the review that the firm's internal inspectors had prepared;
- attended the closing meeting between the engagement team and the firm's internal inspectors; and
- compared its findings with those of the internal inspectors, and discussed with the firm any significant differences;
- read a sample of all the firm's negative response forms from the internal inspection review;
- attended and observed the internal inspection closing conference for the region;
- read and evaluated the firm's internal inspection reports on all the firm's regions; and
- evaluated the effectiveness of the firm's internal inspection program in the region.

The staff also carried out a more limited observation of the internal inspection for a second region. This review included:

- meeting with the national office representatives regarding the status of the internal inspection and plan for wrap-up;
- meeting with the internal inspection team leader to discuss the engagements selected for review;
- selecting two engagements on which to perform a limited review, including a review of certain work papers, review of completed questionnaires, review of any negative response forms and a discussion with the internal review team;
- observing the closing conference for certain engagement reviews; and

- observing the overall regional closing meeting.

The staff observed the general internal quality controls testing related to personnel management that was performed at one office. On a limited basis, the staff re-performed testing on samples selected by the internal inspection team in the areas of training and evaluations.

f. Review of Practices for Establishment and Communication of Audit Policies, Procedures and Methodologies, Including Training

The objectives of the inspection procedures in this area were to obtain an understanding of the firm's processes for establishing and communicating audit policies, procedures and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; to evaluate changes in audit policy that the firm has made; and to evaluate the content of the firm's training on the recently issued Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* ("SAS 99"). Toward those objectives, the staff read, reviewed, and analyzed the following information:

- memoranda explaining the sources of information and communication databases used for policy updates, audit methodology, accounting literature, and a brief explanation as to how the firm develops and revises its policies and procedures;
- a list of the changes made to the firm's audit policies and procedures from May 2002 through July 2003, including changes to internal policies, procedures, manuals, accounting guidance, audit programs, forms, checklists and worksheets;
- internal guidance distributed to assurance personnel setting forth recent changes to accounting and auditing literature and regulations, including those promulgated by the SEC;
- excerpts from internal guidance on SAS 99; and
- training materials for 2002 and 2003 SAS 99 seminars conducted for U.S. partners, audit managers and senior accountants of the firm.

The staff also performed the following procedures at the firm's national office:

- interviewed the DPP Partner in Charge of Risk Management and the DPP Partner in Charge of the firm's Quality Performance Review program to determine how the firm incorporates and communicates changes in its audit policies, procedures and methodologies;
- evaluated the effectiveness of the design of the processes for monitoring developments that might require additions to or changes in the firm's audit policies, procedures and methodologies;
- evaluated the nature and content of recent additions to, or changes in, selected firm audit policies (these included SAS 99, Auditor Independence (SEC Release 33-8183), Conflicts of Interest from Employment Relationships, Communications with Audit Committees, and Disclosure of Accounting Issues to Audit Committees);
- interviewed KPMG's National assurance training partner about the firm's training policies; and
- evaluated the firm's policies, procedures, guidance materials, practice aids, and training materials regarding SAS 99.

g. Review of Policies Related to Foreign Affiliates

The staff performed procedures in this area in order to begin forming a basis on which to evaluate the processes the firm uses to ensure that the audit work performed by its foreign affiliates on the foreign operations of U.S. clients is reliable and in accordance with the standards established by the Board. The staff did not inspect the audit work of foreign affiliates; rather, inspection procedures with respect to such work were limited to a review of evidence of the supervision and control, in accordance with standards established by the Board, exercised by the U.S. firm over such work.

The staff read, reviewed, and analyzed:

- policies and procedures related to the U.S. firm's supervision and control of work performed by the U.S. firm's foreign affiliates on the foreign operations of U.S. issuer clients, including those related to:

- how the U.S. firm ascertains the professional reputation of the affiliated firm;
- procedures the U.S. firm employs to obtain reasonable assurance that the foreign affiliates and their personnel comply with the SEC's independence requirements;
- procedures the U.S. firm employs to obtain reasonable assurance that personnel of the affiliated firm responsible for performing the work on the foreign operations of U.S. issuer clients are familiar with U.S. GAAP, PCAOB standards, SEC independence rules, and relevant SEC financial reporting requirements; and
- procedures the U.S. firm employs to obtain reasonable assurance that foreign affiliates and their personnel understand and comply with relevant audit policies and procedures of the US firm;
- audit guidance related to planning and administering global or multi-location engagements, including matters such as evaluating fraud at individual locations, identifying significant accounts and processes, allocating audit materiality to the location level, and performing risk assessments and customized audit solutions and training;
- a summary of the results of the most recent U.S. and international firm's internal inspections; and
- evidence that professional employees in foreign affiliated firms assigned to U.S. issuer clients have sufficient familiarity with U.S. GAAP and PCAOB standards, independence rules, relevant financial reporting requirements, and the applicable policies of the U.S. firm. This information included:
 - examples of foreign affiliate U.S. GAAP/PCAOB standards training curriculum and meeting topics;
 - an example of a Program for General Matters-Member Firm Independence Controls Review that is completed for all locations visited by the International Quality Performance Review; and

- an example of the 2003 Risk Compliance Checklist that is completed by the Ethics and Independence Partner for each reporting unit of the International firm.

The staff also interviewed the partner responsible for the KPMG International internal inspection program. Finally, at the four practice offices, the staff reviewed two audit engagement teams' supervision and control procedures over the audit work performed by the firm's foreign affiliates on the foreign operations of the U.S. issuers.

B. Observations Concerning Audit Performance

As part of the 2003 limited inspection of KPMG, the staff reviewed certain portions of 16 audit engagements. The selected engagements involved audits of issuers for fiscal years ended in 2002 or early 2003. In addition, the staff's review of KPMG's internal inspection program involved or resulted in the staff reviewing aspects of six additional engagements.

This section describes, at a general level, certain deficiencies in KPMG's audit performance as observed in this review of audit engagements. In some of the engagements reviewed, the staff identified errors in the application of GAAP that KPMG had either not identified or not appropriately addressed during the audit. In addition to those engagements, the staff's discovery of one error prompted a systematic review by KPMG in which it determined that its auditors had overlooked the same error in the financial statements of other clients. In addition, some of the audit engagements reviewed were found to involve some degree of departure from PCAOB standards.

1. Failure to Identify or Address GAAP Exceptions

a. *Staff Discoveries Resulting in Restatements by Issuers*

(1) Six KPMG clients have restated their balance sheets to address GAAP exceptions as a result of the staff bringing to KPMG's attention an issue concerning the application of Emerging Issues Task Force ("EITF") No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*. This resulted after the staff reviewed the financial statements of one issuer that classified as long-term debt the entire balance on a revolving line of credit. Because the credit agreement had both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer

remittances which would be immediately applied to reduce borrowings under the line of credit, the staff concluded that, under the provisions of EITF 95-22, the balances should have been classified as current rather than long-term. KPMG agreed with the staff's view, and the issuer restated certain financial statements to classify the debt as a current liability. The staff asked KPMG to review whether it had failed to detect the same error in other engagements, and KPMG discovered five other such instances that resulted in restatements by the issuers.

(2) The financial statements of one issuer reflected a liability accrual representing the estimated future cost of upgrading devices that both allow the issuer's customers to receive information content provided by the issuer and prevent unauthorized use of that content. The staff concluded that the accrual did not meet the definition of a liability under the provisions of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* ("SFAS 5") and that it should not have been recorded. KPMG and the staff were unable to reconcile their respective views of the appropriate accounting for this matter. The issuer then consulted with the Securities and Exchange Commission, which concurred with the issuer's accounting. The issuer has, however, restated its financial statements to reverse a portion of the accrual on the basis of a different analysis than that advanced by the staff.

b. Other GAAP Exceptions

The staff identified the presence of various other GAAP exceptions. In each case, the issuer and KPMG concluded that the findings were immaterial, individually and in the aggregate. Nonetheless, in some of these cases, the issuer determined to change its accounting, or KPMG determined to recommend accounting changes or enhanced disclosure in future financial statements.^{4/}

(1) During 2002 and 2003, an issuer disposed of foreign investments. As part of the dispositions, the issuer wrote off certain foreign currency translation adjustments, and netted those adjustments in "Unrealized translation adjustments," in the "Statement of Comprehensive Income." The staff concluded that, under the terms of SFAS No. 130, *Reporting Comprehensive Income*, the issuer should have separately reported these reclassification adjustments.

(2) After an issuer completed a transaction that generated certain tax benefits, the issuer chose to recognize approximately 50 percent of the benefits

^{4/} Even if immaterial to current financial statements, some GAAP errors present the potential to be material to future financial statements if the accounting is not corrected.

ratably over the course of the statute of limitations period within which the IRS, under one view of the law, might have challenged the tax benefit. In light of SFAS No. 109, *Accounting for Income Taxes* ("SFAS 109"), the staff questioned the timing of the recognition of the income tax benefits. After the matter was brought to the attention of KPMG's DPP, KPMG and the issuer concluded that recognition of approximately 50 percent of the tax benefit ratably over the statute of limitations period was incorrect and not in accordance with SFAS No. 109.

(3) An amount constituting approximately 23 percent of a restructuring reserve in an issuer's financial statements was identified as relating to "other costs." In the staff's view, that amount did not satisfy the recognition criteria of EITF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* ("EITF 94-3"). After the matter was brought to the attention of KPMG's DPP, DPP agreed that the amount for "other costs" was not a supportable restructuring charge.

(4) The staff believed that a portion of an issuer's accrual for legal exposures was not supportable under SFAS 5, *Accounting for Contingencies*, because it appeared to relate to potential claims and events that had not yet occurred. In response to the staff's concern, KPMG eventually obtained supplemental information from the issuer's in-house counsel. The supplemental information indicated that some of the disputed accrual amount was in fact for asserted claims and therefore appropriate. KPMG agreed with the staff that the accrual was overstated by the remaining amount.

(5) One issuer classified certain excess cash flow certificates as trading securities, in accordance with SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities* ("SFAS 115"), but netted fair value adjustments on, and losses on sales of, those certificates against interest income. The staff concluded that this treatment was inconsistent with SFAS 115, and that the appropriate treatment would be to present the fair value adjustments and the loss on sales of securities as separate line items in the income statement. Failure to do so affects the comparability of the issuer's financial results to those of its peers. After the matter was brought to the attention of KPMG's DPP, DPP acknowledged that the fair value adjustments and the loss on sales of securities should not be netted against interest income.

(6) One issuer did not include loan origination fees and costs in its calculation of gains and losses on mortgage loans sold. The staff concluded that the failure to do so was inconsistent with SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* ("SFAS 91"), and would affect the comparability of the issuer's

financial results with those of its peers. KPMG initially resisted this conclusion but, after further consideration, acknowledged that to be consistent with the intent of SFAS 91, the unamortized portion of deferred loan origination fees and costs should be recognized upon the sale of the related loan and included as a component of the gain or loss on sale of loans in the income statement. KPMG has acknowledged that the approach described by the staff represents the preferred classification, but also takes the position that the approach used by the issuer is also acceptable.

(7) The financial statement footnote disclosure relating to an issuer's charge for impairment of goodwill did not describe the factors that gave rise to the impairment and the valuation method used to determine the amount of the goodwill impairment. The staff concluded that these disclosures are required by SFAS 142, *Goodwill and Other Intangible Assets*. The engagement partner and manager agreed with the staff's conclusion.

(8) An issuer improperly included in "loan administration" income the gains on sales of certain loans. KPMG agreed with the staff's conclusion that the gains should instead be classified as part of the issuer's overall gains on sales of loans.

(9) An issuer failed to classify as part of the gain on the sale of loans certain direct loan origination fees and costs that were related to successful mortgage loan originations. In the staff's view, under SFAS 91, the direct loan origination fees and costs should have been classified as part of the issuer's investment in the loans until sold, and, once the loans were sold, the unamortized portion of deferred fees and costs should have been included in the gain on sale of loans. The failure to properly classify these items would affect the comparability of the issuer's financial results to those of its peers. KPMG has acknowledged that the approach described by the staff represents the preferred classification, but also takes the position that the approach used by the issuer is also acceptable.

(10) One issuer is making payments over a fixed-term on a multi-year earn-out related to an earlier acquisition. The earn-out is being paid to the former owners of the acquired company who are now employees of the issuer. At the time of the transaction, the acquisition was determined to be a purchase in accordance with APB 16 and thus all contingent earn-out payments would be treated as goodwill. During 2002, the earn-out clauses of the purchase agreement were renegotiated and the formula for calculating the earn-out was modified, increasing the earn-out by approximately \$100,000. The issuer capitalized the future earn-out payments under the new method as additional goodwill. The staff concluded that since 100 percent of the business was

acquired in the earlier acquisition, amounts paid to those current employees, who had sold the business to the issuer, in excess of that which was originally agreed should be considered compensation and expensed. The KPMG engagement partner agreed with the staff's position.

(11) Another issuer acquired a private company for consideration consisting of an initial cash purchase price and a maximum earn-out provision payable three years after consummation of the transaction. The earn-out provision specified that the former shareholders of the acquired company be employed for a three-year period and that, under certain circumstances, the amount of the earn-out would be calculated based on the length of their employment. A memorandum in the KPMG work papers concluded that any future payment under the earn-out provisions should be considered an additional purchase price for the acquired company, and should be included in goodwill rather than treated as a current period expense for services rendered. The staff, however, concluded that in light of EITF 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*, the earn-out provision's emphasis on continuing employment would cause the arrangement to be more consistent with the payment of compensation for current services than with an addition to the purchase price. After the matter was brought to the attention of KPMG's DPP, DPP acknowledged that any payments made under the earn-out provisions should be characterized as compensation expense. KPMG also informed the staff that there has been no financial statement impact to date as amounts of payments under the earn-out provisions, if any, will not be known for three years.

(12) One issuer's long-term incentive plan included performance stock units ("PSUs") for certain executives. The PSUs are converted to common stock and delivered to the executive upon termination, retirement, death, or change of control. At age 55, the executive can request that the value of any PSUs that have been vested for over six months be transferred to a diversified investment (e.g., a mutual fund) at a conversion amount based on the fair market value of the issuer's common stock at the end of the applicable deferral period for the incentive compensation. The compensation committee has the discretion to determine whether or not the issuer will honor the executive's request. When the executive's employment is terminated, through retirement or otherwise, the executive can receive the value of the diversified investment in cash. The KPMG engagement team concluded that PSU awards should be treated as fixed plan awards. The staff, however, concluded that the long-term incentive plan requires variable plan accounting for the life of the award. Variable plan accounting means that compensation expense would be recognized from the date the PSUs are granted, and the amount of compensation expense recognized in any given period would be based on the value of the issuer's common stock price at the

applicable financial statement reporting date. After the matter was brought to the attention of KPMG's DPP, DPP acknowledged that the long-term incentive plan requires variable plan accounting. The first PSU awards, however, were issued in April 2003, so there was no impact on the 2002 financial statements.

(13) One issuer was counterparty to a forward sales commitment of student loans, but failed to address whether the forward sales commitment met the definition of a derivative financial instrument. The staff believes that the commitment met the definition of a derivative as set forth in SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"). If the forward sales commitment were determined to be a derivative under SFAS 133, the issuer would be required to mark the commitment to market, and account for changes in the value of the commitment in its income statement.

After the matter was brought to the attention of KPMG's DPP, DPP concluded that the commitment is not a derivative, on the basis of DPP's view that liquid markets for student loans do not exist and therefore the loans underlying the sales commitment are not readily convertible to cash. The staff disagrees with that conclusion and believes that a reasonable person may conclude that a liquid market does exist, through Sallie Mae and other student loan secondary market makers, for these instruments. The forward student loan sales commitment in question, however, is immaterial to the issuer's financial statements. The engagement team modified the 2002 audit work papers to include a memorandum describing the consultation with DPP.

(14) The staff noted that the disclosures required by paragraph 20 of SFAS 71, *Accounting for the Effects of Certain Types of Regulation* ("SFAS 71"), were omitted from the 2002 financial statement footnotes of one issuer. According to KPMG personnel, the engagement team had recommended that the issuer include such disclosure in the 2002 financial statements, but the issuer had chosen not to make the disclosure and KPMG agreed with the issuer that the omission of this disclosure did not materially misstate the financial statements. KPMG personnel also stated, however, that KPMG would again discuss with the issuer the need for this disclosure.

2. Departures from PCAOB Standards

a. *Staff Discoveries That Led to Additional Procedures by KPMG*

In the following cases where the staff identified departures from PCAOB standards, KPMG performed additional audit procedures as a result of the staff identifying deficiencies.

(1) In one case, the documented audit procedures related to a warranty liability consisted only of recalculating the accrual based on the methodology used by the issuer. After the staff questioned the sufficiency of the audit procedures performed on the warranty liability, KPMG performed additional audit procedures. KPMG indicated that it would document the analysis of the issuer's warranty accrual methodology and the additional audit procedures performed thereon in the 2002 work papers, and that it would perform similar audit procedures in the future.

(2) KPMG's 2002 work papers for one engagement reflected that the issuer uses a third-party service organization to perform all customer billing functions and to maintain certain statistics. The documented tests of controls, in KPMG's work papers, did not establish any basis for reliance on the data provided by the third-party service provider, and KPMG's work papers indicated that no reliance would be placed on the controls of the third party. After the staff questioned the sufficiency of the audit procedures that had been performed to conclude on the completeness, existence, and accuracy of accounts receivable, revenue, and deferred revenue, KPMG performed additional procedures. As a result of the additional procedures, KPMG discovered that a Statement on Auditing Standards No. 70, *Service Organizations* ("SAS 70") Type II report was available from the third party service provider. Under SAS 70, the auditor of the entity that receives services from the service provider may limit the scope of audit work that would otherwise have been performed in the absence of the Type II report. In this case, KPMG determined that the SAS 70 Type II report covered the control objectives for completeness, existence, and accuracy of revenue, accounts receivable, and deferred revenue. KPMG concluded that the addition of this Type II report to the procedures KPMG had performed during the course of the audit provided the necessary support so that the engagement team could conclude that adequate work had been performed in the areas of revenue, accounts receivable, and deferred revenue.

(3) In conducting one audit, the engagement team did not obtain a signed management representation letter as required by AU Section 333 of the AICPA Professional Standards entitled *Management Representations*. After the staff brought the omission to the engagement team's attention, the engagement team obtained from the issuer a management representation letter dated as of the KPMG audit report date. KPMG has added the letter to its 2002 work papers.

(4) The staff noted on three engagements that audit work papers did not adequately evidence the audit personnel's performance of procedures on the underlying data, and did not document significant assumptions and estimates, including thought processes, related to tax provisions. KPMG's policy is that the

audit team is responsible for such procedures, and is set forth in PPL No. 01-122, *Tax Review Policies for Audit Engagements*, issued in November 2001.

b. Additional Departures Other than Documentation Deficiencies

The staff identified various other departures from PCAOB standards that involved deficiencies other than documentation deficiencies. In each case, the staff concluded that the circumstances overall did not warrant a conclusion that the financial statements had not been audited in accordance with PCAOB standards.^{5/}

(1) In one case, the work papers did not document the observation or extent of test count procedures related to the issuer's perpetual inventory cycle count. According to the engagement team, it observed the issuer's internal cycle count procedures on one day at one location, but did not perform independent test counts or subsequent tracing of the physical counts to perpetual physical inventory records. The staff concluded, and the engagement partner acknowledged, that PCAOB standards required these procedures.

(2) The work papers for one engagement did not reflect any testing of data, supplied by a related party, concerning assets under management and sales of mutual funds, which are related to the issuer's revenue. It appeared that appropriate audit procedures had been performed on the majority of the revenue, but audit testing for the remainder of the total revenue consisted only of an analytical review. The staff concluded that the analytical procedure should have, at a minimum, been supported by tests verifying the amounts of the assets under management supplied by the related party. The engagement team initially represented to the staff that this asset management data had been tested by KPMG Information Risk Management ("IRM") specialists (computer audit specialists). But after the staff asked for documentation of IRM's audit work, the engagement team discovered that IRM had, in fact, not tested all aspects of the system that produces the related party's data, and the engagement team acknowledged that the staff's conclusion was correct.

^{5/} To reach this conclusion, the staff considered the inherent risk of misstatement of the financial statement component at issue and of the relevant audit assertions, the materiality of these items, the impact of any relevant internal controls of the issuer, and the extent and nature of other relevant substantive procedures that the audit team carried out.

(3) In one case, an issuer consolidated two special purpose entities ("SPEs") onto the balance sheet. Prior to consolidation, the SPEs were not on the balance sheet but were reported as operating leases. As part of an overall debt restructuring, the issuer assumed direct responsibility for the SPE debt service and, accordingly, deemed it necessary to consolidate the SPEs because they no longer met the criteria for non-consolidation. The issuer recorded assets and liabilities at book value. The staff noted that the work papers did not include any memoranda or analysis that considered and documented whether a write-down to fair value was required. The KPMG engagement team acknowledged that documentation was not present in the work papers and that no specific consideration had been given to whether the SPEs should be consolidated at fair value or original cost. KPMG's DPP ultimately concluded that the accounting treatment was acceptable, and the engagement team supplemented the work papers with a contemporaneously dated memorandum^{6/} concerning the consultation with DPP.

(4) The work papers for one engagement did not include evidence that the written communications required by Independence Standards Board Statement No. 1, *Independence Discussions with Audit Committees*, ("ISB No. 1") were provided to the issuer's audit committee. ISB No. 1 requires auditors of SEC registrant companies to provide written communications to the registrant company audit committee related to any relationships between the issuer and the auditor's firm that may have a bearing on independence, the auditor's notification that they are independent under the definition of prevailing securities laws, and other independence-related matters for audit committee discussion. The engagement partner and manager responsible for the 2002 audit are no longer with KPMG. The new engagement partner and the business unit professional practice partner of the practice office in question acknowledged that the letter was not in the files and agreed to issue a letter containing the communications required by ISB No. 1 to the issuer's audit committee and include a copy of the communication in the work papers.

c. Additional Departures Concerning Documentation

The staff noted various additional documentation deficiencies in the engagements reviewed. With respect to these deficiencies, the staff concluded either that other evidence allowed the staff to reach the same conclusions that

^{6/} As used in this report, any reference to "contemporaneous" dating of a document means that the document is dated contemporaneous with the creation of the document.

the engagement team had articulated, or that, despite a lack of other evidence, those deficiencies did not render the audit as a whole deficient.^{7/}

C. Certain General Observations

As intended, the 2003 limited inspection of KPMG has provided an important foundation for more far-reaching inspections of the firm. Within the seven functional areas, the Board has identified issues that will warrant more probing scrutiny in a full-scale inspection, and examination of these issues will continue in annual inspections of KPMG. These issues, however, do not lend themselves to a thorough critique on the basis of a single, limited inspection.

As a general matter, the Board is encouraged by indications that the mere anticipation of a review of the firm's practices may already have had a positive effect on the firm, as the staff found a number of recent changes to firm policies and procedures relating to some of the seven functional areas. The Board is also encouraged by indications that the firm understands that the Act calls for a renewed and heightened focus on audit quality. In addition, the firm was cooperative and responsive with respect to questions raised by the staff about compliance with auditing standards and accounting principles.

Even so, the Board intends to maintain a critical eye, through the inspection process, on the development of the firm's initiatives, and their impact on audit quality, over time. The limited inspection has revealed issues that Board inspectors will probe more deeply in future inspections and that the Board will expect the firm to address as the Board refines its understanding of the firm's practices.

END OF PART I

PART III OF THIS REPORT IS NONPUBLIC AND IS OMITTED FROM THIS PUBLIC DOCUMENT

^{7/} The staff reached that conclusion based on consideration of the inherent risk of misstatement and the materiality of the financial statement component at issue, combined with the extent and nature of other related internal control and substantive audit procedures carried out.

PART III

RESPONSE OF KPMG TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided KPMG an opportunity to review and comment on a draft of this report. KPMG provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change made to the report before the Board finalizes the report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the firm's response that address nonpublic portions of the report are omitted.



345 Park Avenue
New York, NY 10017

Telephone 212 758 9700
Fax 212 872 3001

July 22, 2004

Mr. George Diacont
Director – Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006

Re: Response to Public Company Accounting Oversight Board (PCAOB) Draft Report of 2003 Limited Inspection of KPMG LLP

Mr. Diacont:

Your 2003 limited inspection provided PCAOB the opportunity to view first hand the people at KPMG and our commitment to quality, ethics and independence. As your inspection report notes, KPMG personnel were cooperative and responsive in their dealings with your staff -- an indication of how serious and important we believe this process is to each of us. We are extremely proud of the conscientious work effort that KPMG people put forth on each and every audit in a very complex and challenging accounting and regulatory environment.

Furthermore, we at KPMG were impressed with the qualifications of the PCAOB staff and their thoroughness, dedication and attention to detail in conducting this initial limited inspection. We share the common goals of improving audit quality and restoring the public's trust in the capital markets. Your inspection process coupled with the continuous improvements we are making in our system of quality controls represents an essential step in that direction.

The PCAOB's inspection process delivers an objective critical view of our initiatives and work product. While we may have differing views on specific audit engagement matters, our mission critical goal is to continuously improve audit quality by evolving the depth and breadth of our audits to conform to the standards being set by the PCAOB. We welcome your comments in that context. We are making and will continue to make improvements in our audit methodology and engagement execution and will maintain our close cooperation with the PCAOB as it continues its ongoing inspection process.

We, at KPMG, look forward to a continuing, constructive dialogue on the issues facing our profession. We appreciate the opportunity to respond to your draft 2003 limited inspection report. Our comments below respond to the section entitled "Observations Concerning Audit Performance" included in Part I of the draft report and are offered to assist a reader in understanding both the qualitative and quantitative aspects of the find-





Mr. George Diacont
July 22, 2004
Page 2

ing and to provide a context to the finding, including the enhancements we are undertaking as a firm.

Staff Discoveries Resulting in Restatements by Issuers

(1) Of the sixteen engagements selected for review, the PCAOB staff identified a situation in which the issuer incorrectly classified its debt as a long-term liability instead of a short-term liability as a result of the misapplication of Emerging Issues Task Force (EITF) Abstracts Issue No. 95-22, *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*. KPMG's Department of Professional Practice (DPP) agreed with the PCAOB staff's conclusion and we made a request to the issuer to restate its balance sheet to reflect the appropriate accounting in accordance with EITF No. 95-22. The issuer subsequently restated its prior year and quarterly financial statements to correct the misapplication of EITF No. 95-22.

In collaboration with the PCAOB staff, KPMG immediately conducted a survey of its issuer clients to determine if other issuers might be misapplying EITF No. 95-22. As a result of this survey, KPMG identified five other situations which resulted in issuers restating either its annual or quarterly financial statements to reflect the correct application of EITF No. 95-22. In addition, DPP issued enhanced technical guidance and practice aids to assist our professionals in identifying the existence of financial agreements that might meet the criteria of EITF No. 95-22 and analyzing such agreements.

While we understand this EITF matter may have broader implications for issuers other than KPMG clients, we note that these restatements constitute technical revisions to debt classification only and do not impact client financial results.

(2) We agree with the facts presented with respect to this liability accrual. This issue is indicative of the significant challenges registrants face evaluating accounting matters in today's environment. In this engagement, KPMG and the PCAOB could not agree on the appropriate application of generally accepted accounting principles (GAAP) and consulted with the Securities and Exchange Commission (SEC). The SEC agreed with KPMG on the matter raised by the PCAOB, but questioned a different element of the accrual, ultimately requiring restatement by the issuer. In short, three knowledgeable, informed bodies (the PCAOB, the SEC and KPMG) reviewed these facts and reached different conclusions regarding the application of generally accepted accounting principles, il-



Mr. George Diacont
July 22, 2004
Page 3

lustrating the complex accounting issues registrants, auditors and regulators all face.

Other Exceptions

As the PCAOB states, the issuers and KPMG concluded that all other GAAP exceptions cited in the draft report were deemed immaterial to the issuers' financial statements, *both individually and in the aggregate*. Moreover, more than half of the exceptions noted related to presentation and disclosure matters. The remaining exceptions involved measurement issues which did not materially affect the issuer's reported net income. In addition, certain exceptions were noted concerning the completion of auditing procedures and the related documentation thereof which were satisfactorily resolved with the PCAOB staff.

While the exceptions noted above are immaterial, we have recognized opportunities for improvement in executing our audits. Specifically, we are performing an intensive review of our existing clients to evaluate partner and manager workloads thereby ensuring that our people have the appropriate time to supervise and review their respective engagements. We are resigning from many clients to create the additional capacity needed by our professionals, recognizing both the need to increase the scope and depth of our audit procedures and the new requirements to report on internal control over financial reporting.

Further, the firm has recently provided three sets of skilled resources which the engagement team can deploy in our audits, where appropriate. First, the Tax Provision Reviewing Partner network was formed. These audit and tax partners will provide additional training to professionals in the area of tax provisions and have introduced a more extensive tax provision audit program to enhance substantive audit procedures in this area.

Second, an audit training and methodology partner role was created. Residing in local offices, this partner specializes in the firm's audit methodology and serves as a resource to local engagement teams as we roll out the implementation of new professional auditing standards and continue to evolve our audit methodology to address today's changing environment. These individuals allow us to bring real time training, developed nationally and delivered locally, to our audit professionals.

Third, an Audit Quality Council (AQC) has been formed to reassess the firm's audit-related training. The AQC brings together the experiences of a group of partners to discuss issues arising from audit engagements and internal and PCAOB inspection results to recommend areas that training should address. For example, in our national and local office training sessions, we have increased the focus on the importance of including ap-



Mr. George Diacont
July 22, 2004
Page 4

propriate documentation within the audit work papers. Furthermore, we stress the critical need for the audit engagement partner and manager to analyze the accounting implications that the client's major contracts may have on the company's financial statements.

We trust our comments are responsive to the draft report and we also look forward to reviewing with the Board our detailed action plan to address the Board's observations. In closing, the professionals of KPMG understand the importance of strengthening our firm and the profession as we work with the PCAOB in restoring the public's trust in the capital markets. Questions regarding this letter should be directed to Michael J. Baum, (212) 909-5604, mjbaum@kpmg.com.

Very truly yours,

KPMG LLP